

Report of Examination of

Dealers Assurance Company
Columbus, Ohio

As of December 31, 2009

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Columbus, Ohio
February 7, 2011

Honorable Mary Taylor
Lt. Governor/Director
State of Ohio
Department of Insurance
50 West Town Street
3rd Floor – Suite 300
Columbus, Ohio 43215

Honorable Joseph Torti III
Chairman, NAIC Financial Condition (E) Committee
Deputy Director and Superintendent
Insurance and Banking
State of Rhode Island
1511 Pontiac Avenue, Bldg. 69-2
Cranston, Rhode Island 02920

Dear Directors:

In accordance with Section 3901.07 of the Ohio Revised Code (“ORC”), the Ohio Department of Insurance (“Department”) conducted an examination of

Dealers Assurance Company

an Ohio domiciled, stock, property and casualty insurance company, hereinafter referred to as the “Company.”

Scope of Examination

The Department of Insurance last examined the Company as of December 31, 2004. The Department’s current examination covers the period of January 1, 2005 through December 31, 2009.

The Department conducted the examination in accordance with the National Association of Insurance Commissioners (“NAIC”) Financial Condition Examiners Handbook (“Handbook”). The Handbook requires that the Department plan and perform the examination to evaluate the financial condition and identify prospective risks of the Company by obtaining information about the Company, including corporate governance, identifying and assessing inherent risks within the Company, and evaluating system controls and procedures used to mitigate those risks. An examination also includes assessing the principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation, management’s compliance with Statutory Accounting Principles and annual statement instructions, when applicable to domestic state regulations.

All accounts and activities of the Company were considered in accordance with the risk-focused examination process.

For all years under examination, the Certified Public Accounting firm of Munninghoff, Lange and Co. provided an unqualified opinion on the financial statements based on Statutory Accounting Principles. The audited financial reports were reviewed during the examination.

Management and Control

Board of Directors

Management of the Company is vested in its Board of Directors, which was comprised of the following members as of the examination date:

Name	Principal Occupation
Kirk A. Borchardt	President and Chief Executive Officer, Dealers Assurance Company
Robert W. Price	Retired Chief Financial Officer, Southwest Re Holdings, Inc.
James B. Smith	Chairman and Chief Executive Officer, Southwest Re Holdings, Inc.
Sharon M. Spohn	Secretary and Treasurer, Dealers Assurance Company

Officers

As of the examination date, the following officers were serving in the designated position:

Name	Title
Kirk A. Borchardt	President and Chief Executive Officer
Sharon M. Spohn	Secretary and Treasurer

Insurance Holding Company System

The Company is a member of a three-tiered holding Company system headed by Southwest Re Holdings, Inc. ("SWRE"). SWRE is a Delaware holding company that was formed in 2003 to facilitate the acquisition of the Company and its affiliates by its current shareholders. SWRE owns 100% of the outstanding stock of Dealers Alliance Corporation ("Alliance"), which had been the historical parent of the Company prior to the SWRE acquisition. Alliance, in turn, owns 100% of the outstanding stock of the Company.

Approximately 95% of SWRE's outstanding shares are owned by individuals or entities that obtain insurance from the Company. Of this amount, 60% of SWRE's common shares are owned by one individual who also owns a service contract provider, generally referred to as an Administrator Obligor ("AO"), that is insured by the Company, and a 28% block of shares is owned by related individuals who own an AO insured by the Company. The remaining 5% shares of SWRE are owned by current and past management personnel.

Territory and Plan of Operations

The Company is licensed to write property and casualty insurance in the District of Columbia and all states except Hawaii.

The Company's primary business strategy is to write contractual liability insurance policies ("CLIPs") covering AOs who issue service contracts to the purchasers of consumer products. Roughly 90% of the Company's business comes from the automotive field and 10% comes from the consumer electronics and home appliances field.

The Company's CLIPs follow one of two structures: (i) a CLIP that provides aggregate excess of loss coverage to the AO in excess of an aggregate deductible on the policy; and (ii) a CLIP that provides first-dollar coverage, which insures every dollar of loss under the service contracts. In either case, the Company's policy provides a direct cut-through right in favor of the consumer in the event the AO fails to perform under the service contract within the specified time.

Under the aggregate excess of loss CLIP structure, the claims reserves are not recorded in the Company's financial statements; however, the Company requires the AO to fund a trust account, with the AO as grantor and the Company as beneficiary, as security for the AOs performance of all obligations of the service contracts. If the unearned claims reserves set aside by the AO prove to be insufficient to pay claims, then the Company may be liable to pay claims once the AOs reserves have been depleted. At year-end 2009, over twenty-five AOs were insured under aggregate excess of loss CLIPs with approximately \$221 million in unearned claims reserves held in trust, or supported by letters of credit, by the insured AOs.

During 2009, the largest states in terms of direct premiums written were as follows: New Mexico, \$7.6 million (13.6%); New York, \$7.2 million (12.8%); Texas, \$6.8 million (12.1%); California, \$5.4 million (9.7%) and Colorado, \$3.5 million (6.2%).

The following schedule illustrates the Company's premium written in 2009 by line of business, reported in thousands:

<u>Line of Business</u>	<u>Direct</u>	<u>Assumed</u>	<u>Ceded</u>	<u>Net</u>
Warranty	\$55,552	\$4,569	\$56,813	\$3,308
Other liability, occurrence basis	<u>498</u>	<u>0</u>	<u>0</u>	<u>498</u>
Totals	<u>\$56,050</u>	<u>\$4,569</u>	<u>\$56,813</u>	<u>\$3,806</u>

Reinsurance

The Company maintains quota share reinsurance agreements with numerous producer-owned reinsurance companies (PORCs) to cede 100% of warranty premiums. The Company has either established a trust agreement for each PORC to collateralize unearned premium or holds funds to support unearned premium reserves.

Significant Operating Results

The Company reported the following net underwriting results during the examination period, reported in thousands:

	2009	2008	2007	2006	2005
Premiums earned	<u>\$ 7,818</u>	<u>\$ 11,214</u>	<u>\$ 9,930</u>	<u>\$ 7,084</u>	<u>\$ 5,243</u>
Losses incurred	(1,069)	1,899	3,207	2,011	1,960
Loss adjustment exp. incurred	281	284	474	423	430
Underwriting expenses incurred	<u>2,220</u>	<u>2,302</u>	<u>4,235</u>	<u>2,558</u>	<u>2,386</u>
Total underwriting deductions	<u>1,432</u>	<u>4,485</u>	<u>7,916</u>	<u>4,992</u>	<u>4,776</u>
Net underwriting gain	<u>\$ 6,386</u>	<u>\$ 6,730</u>	<u>\$ 2,014</u>	<u>\$ 2,092</u>	<u>\$ 467</u>
Pure loss ratio	(13.7)	16.9	32.3	28.4	37.4
Loss adjustment expense ratio	<u>3.6</u>	<u>2.5</u>	<u>4.8</u>	<u>6.0</u>	<u>8.2</u>
Loss ratio	(10.1)	19.5	37.1	34.4	45.6
Underwriting expense ratio	<u>58.3</u>	<u>82.0</u>	<u>26.1</u>	<u>21.0</u>	<u>29.4</u>
Combined ratio	<u>48.3</u>	<u>101.5</u>	<u>63.1</u>	<u>55.3</u>	<u>75.0</u>

Financial Statements

The financial condition and the results of its operations for the period under examination as reported and filed by the Company with the Department and audited by the Company's external auditors, are reflected in the following:

Statement of Assets, Liabilities, Capital and Surplus

Statement of Income

Statement of Changes in the Capital and Surplus Account

**Statement of Assets, Liabilities, Capital and Surplus
December 31, 2009**

Bonds	\$ 48,850,725
Common stocks	2,948,250
Cash and short term investments	7,018,167
Receivables for securities	<u>677</u>
Subtotal, cash and invested assets	58,817,819
Investment income due and accrued	513,754
Uncollected premiums in course of collection	1,636,971
Net deferred tax asset	367,236
Accounts receivable	<u>127,771</u>
Total admitted assets	<u>\$ 61,463,551</u>
Losses	\$ 18,178
Loss adjustment expenses	1,096
Commissions payable	566,128
Other expenses	259,964
Taxes, licenses and fees	258,812
Unearned premiums	13,128,213
Ceded reinsurance premiums payable (net of ceding commissions)	1,116,269
Funds held by Company under reinsurance treaties	2,703,160
Amounts withheld or retained by Company for account of others	<u>6,814,563</u>
Total liabilities	<u>24,886,383</u>
Common capital stock	4,200,990
Surplus notes	3,000,000
Gross paid in and contributed surplus	9,232,810
Unassigned funds	<u>20,163,368</u>
Total capital and surplus	<u>36,597,168</u>
Total liabilities, capital and surplus	<u>\$ 61,463,551</u>

Statement of Income
As of December 31, 2009

Premiums earned	<u>\$ 7,818,452</u>
Losses incurred	(1,068,597)
Loss adjustment expenses incurred	280,674
Other underwriting expenses incurred	<u>2,220,160</u>
Total underwriting deductions	<u>1,432,237</u>
Net underwriting gain	<u>6,386,215</u>
Net investment income earned	1,621,932
Net realized capital gains (losses)	<u>(423,055)</u>
Net investment gain	<u>1,198,877</u>
Miscellaneous income	<u>50,791</u>
Total other income	<u>50,791</u>
Income before federal income taxes	7,635,883
Federal income taxes incurred	<u>2,470,288</u>
Net income	<u>\$ 5,165,595</u>

Statement of Changes in the Capital and Surplus Account
(in thousands)

	<u>2009</u>	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>
Capital and surplus, prior year end	<u>\$32,650</u>	<u>\$27,977</u>	<u>\$25,612</u>	<u>\$14,351</u>	<u>\$13,835</u>
Net income	5,165	5,270	2,332	2,207	672
Change in net unreal. cap. gains (losses)	816	(874)	(40)	0	(197)
Change in non-admitted assets	(1,775)	27	42	43	43
Change in provision for reinsurance	0	0	0	0	9
Capital changes	0	0	1,172	0	0
Surplus adjustments	0	0	(1,172)	9,000	0
Other gains (losses) to surplus	<u>(259)</u>	<u>250</u>	<u>31</u>	<u>12</u>	<u>(11)</u>
Change in surplus for the year	<u>3,947</u>	<u>4,673</u>	<u>2,365</u>	<u>11,261</u>	<u>516</u>
Capital and surplus, current year end	<u>\$36,597</u>	<u>\$32,650</u>	<u>\$27,977</u>	<u>\$25,612</u>	<u>\$14,351</u>

Notes to Financial Statements

Investments

The Company's investment portfolio consists primarily of investment grade bonds and a money market fund. The bonds were in compliance with ORC Section 3925.08 and valued in accordance with the relevant Statements of Statutory Accounting Principles and the NAIC Securities Valuation Office.

Loss and Loss Adjustment Expense Reserves

The Company's Board of Directors appointed Joseph Kirsits, FCAS, MAAA, Vice President, GPW Actuarial Services, Inc. ("GPWAS"), to render the Company's Statement of Actuarial Opinion ("Opinion"). Under the direction of Mr. Kirsits, GPWAS prepared an Actuarial Report supporting the Opinion in connection with the preparation of the Company's December 31, 2009 Annual Statement.

Oliver Wyman Actuarial Consulting, Inc. ("Oliver Wyman") was retained to assist the Department with its examination of the Company. Oliver Wyman provided a high level review of the Actuarial Report prepared by GPWAS, including a review of overall methodology and assumptions. Oliver Wyman also reviewed the ultimate losses for three of the largest AOs in terms of reported liabilities.

Oliver Wyman's analysis consisted of estimating the unpaid liability resulting from the written premium of AOs insured by the Company, primarily from auto service contract obligations. This estimated liability was compared to funds held in trust specifically for these service contracts, and any shortfall becomes an obligation to the Company under its CLIPs. The results of Oliver Wyman's analysis indicate the unpaid liabilities calculated by GPWAS are reasonable for the AOs reviewed.

Oliver Wyman identified expected trust deficiencies associated with one of the AOs that was reviewed. The amounts of the expected trust deficiencies were not materially different than those determined by GPWAS. Management of the Company has represented that an unassigned Letter of Credit in the amount of \$5 million is available to offset any projected deficiencies associated with the business of this AO.

Mary D. Miller, FCAS, MAAA, Assistant Director, Product Regulation and Actuarial Services, with the Department, reviewed the Actuarial Report provided by GPWAS and the Oliver Wyman reserve analysis. Based on these reviews, the loss and LAE reserves presented in the Company's 2009 annual statement are reasonable.

Conclusion

The balance sheet contained in this Report of Examination reflects the financial condition of the Company as of December 31, 2009, and is summarized as follows:

Total Assets	<u>\$ 61,463,551</u>
Liabilities	24,866,383
Capital and Surplus	<u>36,597,168</u>
Total Liabilities, Capital and Surplus	<u>\$ 61,463,551</u>

Subsequent Events

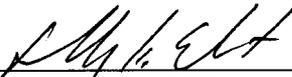
In 2010, Edmond Eckert, Vice President, Marketing, was added to the Board of Directors.

Acknowledgement

Appreciation is expressed for the assistance extended by the officers and employees of the Company and its affiliates during the course of this examination.

In addition to the undersigned, Jeffrey Ferris, AES, CFE, CISA; Ryan Gibson, CFE; Dominik Ilc, AES, CFE, CISA; Nicholas Kostoff, CFE; Floyd Meeks, AES, CFE, CISA; Mary Miller, FCAS; Edward Nagorny, CFE; Brad Schroer; and of the Department, participated in this examination.

Respectfully,



Jeffrey K. Ebert, CFE
Assistant Chief Examiner
Office of Risk Assessment
Ohio Department of Insurance

Verification

As required by Section 3901.07 of the Ohio Revised Code, the undersigned hereby attest to the best of their knowledge and belief that the attached is a true Report of Examination as of December 31, 2009.

J. K. Ebert 2/15/2011
Assistant Chief Examiner Date

State of Ohio

County of Franklin

Personally appeared before me the above named Jeffrey K. Ebert personally known to me, who executed the above instrument and that the statements and answers contained therein are true and correct to the best of his/her knowledge and belief.

Subscribed and sworn to before me this 15 day of February, 2011.

Elizabeth Chase
(Notary Public)
ELIZABETH CHASE
NOTARY PUBLIC, STATE OF OHIO
~~MY COMMISSION EXPIRES MAY 22, 2012~~
My Commission Expires